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ENCLOSURE Translation of Report on Currency Stabilization

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The Chinese economy has now reached its most critical state since the conclusion of the Japanese war. Communications, even outside the civil war zone, have not been restored. Industrial production has been seriously handicapped by accelerating inflation, obsolescence of equipment, dislocated transport, higher real wages and low productivity, lack of raw materials, and in urban centers, serious shortage of electric power. The low industrial productivity and corresponding dislocation of agricultural supplies has created an urgent need for subsistence supplies of food and materials from foreign sources, resulting in a seriously unfavorable balance of trade, met by a low, and fast dwindling foreign exchange reserve. After the completion of the UNRRA program, which has supplied a large volume of both relief and rehabilitation materials, the presently imposed import quota may be too low to meet the urgent requirements of the country, and certainly may be regarded as allowing no room for industrial or agricultural development. Internally, so long as the civil war continues, the Government deficit will continue and domestic prices will more or less reflect the inflated situation, as a result of more money being available for less goods and services.

The present situation can be attributed to several causes: but fundamentally to the imposition of a civil war upon a country already torn by the recent World War, from which it emerged victorious but with its undeveloped interior exhausted by the Japanese war, its coastal urban and lightly industrialized areas bled by the Japanese, and its industrialized, and economically developed Northeastern areas stripped by the Soviets. Both a contributing cause and an index of the situation is the inflation, operating in three spirals: inflation-deficit, where the time lags between revenue and expenditure in a period of accelerating prices prevent balance, with the in-balance being met by more notes: inflation-confidences, where rising prices create a psychology to discredit the currency and cause a general flight from currency to goods: inflation-production where rising prices result in maladjustment and dislocation of production and therefore a final reduction in the aggregate national product. The effect is either to accelerate inflation or to increase administrative difficulties in checking the upward course of inflation.

The inflationary spirals have acted and reacted upon each other. To check inflation, promote industries and balance the government budget, it is necessary to break these three spirals at the same time.

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For the general economic recovery, China must stop the present inflation. A stable price level will restore industries by checking speculation so that useful resources and subsistences may be shifted to productive uses, by coinciding the real profit and the money profit of business so that entrepreneurs may realize their real positions and improve their efficiency, by forcing the inefficient firms to close down so that both the competition for factors of production and therefore factor prices may be reduced, and by lowering the money rate of interest so that industries may have a more balanced and healthy development. It will help the income of the salary class to catch up with prices so as to increase the administrative efficiency both in the Government and in private organizations. It will also help reduce the Government deficit by increasing production which means an increase in the taxable income, by reducing the possibility of tax evasion due to the necessity of falsifying the accounts during inflation, by reducing the differences in the purchasing power of money between the times of private income and of government revenue and by the general favorable psychological effects which may allow the Government to improve the old revenues to levy new taxes or even to issue bonds.

It is probably impossible to stop the spirals from within. Under civil war conditions, even with heavily reduced government expenditures using its utmost efforts to improve the situation, by limiting deficit spending, moderating the rate of price increase, promoting industries and increasing exports, these measures cannot be adequate. Following the prolonged and destructive Japanese war, with every phase of the economic machine in disorder, there is little hope that the situation can be solved by China herself in a short time. If there is assistance from outside of the domestic economy, the cumulative momentum may be checked and ultimately stopped in a measurable period.

There are two ways of rendering economic assistance from the outside. One way is to supply a flow of commodities, either capital equipment, materials or subsistence, to tide over the difficulty and to improve the economic productivity. Another way is to provide sufficient resources to stabilize the currency so as to reestablish a normal environment for healthy growth. Both are important. Without a stable currency, business cannot be operated on a normal basis and it is very likely that part of the imported goods would be wasted. Should the currency be stabilized earlier, the effect of the UNRRA program in restoring

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the national economy, and to a greater extent, a stable currency, which ensures a sense of stability and help to increase the administrative efficiency.

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EFFECT OF INFLATION ON PRODUCTION

China's agricultural production in 1946, except wheat and corn, was less than prewar years. The reduction can be attributed to many war factors, but two of them can be more evidently supported by statistics; the loss of work animals and the lack of chemical fertilizer. In comparison with the 1934-37 average, water buffaloes were reduced in 1946 to 72%, cattle to 64%, horses to 54%, mules to 53% and donkeys to 62%. As China does not produce much fertilizer, she depends on imports, and 1946 import was only 38% of her 1935-36 average. Decreases in certain production were also accompanied by decreases in the production of meat animals and poultry. For example, goats were reduced in 1946 and 1947 to 67% and 79% respectively, sheep to 52% and 66%, hogs to 73% and 83%, chickens to 67% and 79%, ducks to 70% and 74%, and geese to 59% and 70%.

Coal production in China Proper (i.e., excluding Northeastern Provinces and Taiwan) was $\frac{1}{2}$ as much as that in 1936, chiefly because of military operations and partly because of lack of equipment. On the other hand, import of coal was reduced to 10%. Electric power capacity in Shanghai, relatively the most developed industrially in China, was, even though with a substantial increase after V. J. Day, still less than the prewar level. All mineral productions were greatly reduced. Excluding the Northeastern Provinces, iron ore production in 1946 was only 0.8% of 1936, pig iron 1%, steel 33%, tungsten ore 23%, antimony 3%, tin 15%, and salt 71%. Prices of metal products were high and imports of machinery were, except electric and textile machinery, all reduced. For example, machine tools were reduced to 40%, hand tools to 0.4%, and prime mover and parts to 64% of prewar.

Not only does the reduction in food production raise the relative prices of foodstuffs, but speculation during inflation raises it even more. Farmers will not sell their crops until they need to buy products from other producers. Housewives try to increase their holdings of all daily necessities, of which food and clothing materials are the most important to hoard. As these goods constitute the chief items consumed by wage earners, the rise of their relative prices also increased wages relative to other manufactured products. On the other hand, as any

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banks, there is a tendency during inflation of multiplication of firms, including small factories, workshops, trading concerns, and banks. With limited resources available, an increased number of firms compete in the market for materials, labor and equipment, and bid up all cost of production. An accompanying table shows the relative change of production cost factors compared with prices of finished products in Shanghai. We may see that, since 1944 even during the Japanese occupation, prices of foodstuffs and raw materials rose faster than prices of manufactured producers goods, prices of producer goods rose faster than those of consumer goods. This reduced the margin for manufactured products. The price trend after the reoccupation only continued this tendency. In the last column of the table real wages before the freezing of the cost of living index are shown as more than 10% higher than the prewar level.

This is a very serious and even critical situation. Up to 1944 prices of manufactured goods rose faster than food and raw materials. The extra profits to the manufacturers might have either decreased the efficiency of the producers or have increased the number of firms, or both. With the change of relative price and wage factors unfavorable to the producer, many of the existing firms become marginal or even submarginal unless their efficiency could be improved. As a matter of fact, production efficiency of every field in every phase has been greatly reduced. Firstly, the multiplication of firms, induced by the ten-year long inflation, which competes for equipment, materials, power and labor find these factors so limited in supply, especially after a major war and with limited foreign exchange resources, that they are not sufficient to meet the demand of the increased firms. The shortage is accentuated by the dislocation of transportation system and the fight with the Communists which restricts the movement of goods. The result is a general reduction in the efficiency of production in the sense that it lacks a proportionality between the different kinds of equipment themselves, and between equipment and materials, power and labor. Its apparent phenomena is that many firms are not operating in full capacity. Secondly, as money rate of interest must rise during inflation, it practically prohibits any planning by the entrepreneurs longer than the immediate future. On the other hand, any credit at low rate of interest granted by the Central Bank means further inflation. As a result, only the more rudimentary and inefficient equipment may be used profitably, unless they may be imported at an exchange rate which is far below market rate. Thirdly, the managerial efficiency is also reduced.

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obtain other incomes to supplement their regular salaries in order that they may not be starved. The better ones might secure a concurrent job in schools or business concerns, and the worse ones had to resort to irregular means. It was only the hope of a final victory over the Japanese by allied nations that kept up the morale.

In the Japanese occupied areas, while the economic situation was much better off than in the interior, there was another element leading to corruption. Many of the officials in the puppet Government joined the regime half heartedly just for a living. They tried to obey or disobey orders whenever possible. Corruption became the fashion and can be proud of, rather than crime. It was the supremacy of the Japanese military force and the iron hand of the Japanese administration that maintained order in the occupied areas.

After V. J. Day, internal hostilities broke out and the situation became even more disappointing than during the years of the Japanese war. The inflation, which was started during the war, cannot be checked with the dislocated productive machinery. To prevent laborers from turning to the Communists, the Government had assisted them to increase their wage so that, although the national productivity is much reduced, the real income is much higher than pre-war years. The higher wage together with lower productivity raised the production cost, which in turn raised general prices and decreased employment and production. This factor, in addition to the civil war, means more vigorous inflation. As a result, real income of the lower bracket of Government employees falls much below those of unskilled workers. On the other hand, the habits and technique of corruption as acquired during the Japanese occupation applied more widely to the present administration after the Government returned to Nanking. The original hope before V. J. Day for an early peace is gone. The iron hands of the Japanese administration are lacking. There is nothing more to keep the morale. It is understandable how there cannot be any incentive to work when the income is below the subsistence level without any foreseeable future. Efficiency is low and corruption prevails anywhere when supreme supervision is insufficient.

To restore morale and efficiency, it is necessary to have (1) a foreseeable peace either by military or by political settlement, and (2) a stable income for Government officials sufficient for a decent living.

To increase efficiency by raising the salaries of Government employees, there involve

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PRICES AND WAGE RATES IN SHANGHAI*

| | Food & Raw Materials | MANUFACTURED GOODS | | | WAGE | |
|-------|----------------------------|---------------------------|--------------------|--------------------|--------------------|----------------------------|
| | | All Mfd. goods | Producers goods | Consumers goods | Factory workers | Non- Factory workers |
| | | 1944 - 1 | | | 1937 - 1 | |
| 1944 | 1 | 1 | 1 | 1 | | |
| 1945 | | | | | | |
| Jan. | | | | | | |
| Oct. | 41.8 | 33.3 | 36.7 | 34.6 | | |
| | | Nov. 1945 - Feb. 1946 - 1 | | | | |
| 1946 | | | | | | |
| Jan. | 0.88 | 0.86 | 0.88 | 0.85 | | |
| Feb. | 1.44 | 1.45 | 1.49 | 1.40 | | |
| Mar. | 2.19 | 1.96 | 2.11 | 1.80 | | |
| Apr. | 2.12 | 1.83 | 1.97 | 1.68 | | |
| May | 2.43 | 1.81 | 1.59 | 1.72 | 1.58 | 2.27 |
| June | 2.57 | 1.91 | 2.00 | 1.81 | 1.92 | 2.03 |
| July | 2.79 | 1.97 | 2.03 | 1.91 | 1.97 | 1.97 |
| Aug. | 2.98 | 1.92 | 1.96 | 1.88 | 1.51 | 2.02 |
| Sept. | 3.46 | 2.27 | 2.31 | 2.24 | 1.43 | 1.77 |
| Oct. | 4.01 | 2.83 | 2.89 | 2.76 | 1.43 | 1.68 |
| Nov. | 4.19 | 2.96 | 3.21 | 2.70 | 1.56 | 1.72 |
| Dec. | 4.32 | 3.37 | 3.73 | 3.01 | 1.56 | 1.72 |
| 1947 | | | | | | |
| Jan. | 5.68 | 4.35 | 4.82 | 3.87 | 1.58 | 1.59 |
| Feb. | 9.54 | 7.64 | 8.35 | 6.47 | 1.31 | 1.32** |
| Mar. | 10.13 | 7.65 | 8.79 | 6.53 | 1.22** | 1.34** |
| Apr. | 12.46 | 9.05 | 10.14 | 7.94 | 1.18** | 1.29** |
| May | 18.36 | 13.37 | 15.46 | 11.35 | | |
| June | 21.01 | 15.08 | 17.00 | 13.16 | | |
| July | 25.24 | 19.79 | 22.68 | 16.93 | | |
| Aug. | 27.14 | 20.28 | 22.81 | 18.87 | | |
| Sept. | 33.13 | 25.46 | 28.63 | 23.69 | | |

* Based on Wholesale Price Index compiled by the China Institute of Economics and wage index compiled by the Ministry of Social Affairs.

** Wage rate stayed at January level from February to May, 1947 by freezing the cost of living index. The statistics after the defreezing of the index are not yet available.

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In Chinese history, there have been two types of political cycles. One is the cycles of peace and war and the cycles of enlightened and corrupted government. The time periods of the two types of cycles may and may not coincide with each other, though they usually interacted upon each other.

As the majority of the Chinese people lack political interest and are indifferent towards the Government except concerning the amount of the tax to be paid, the efficiency of administration does not depend upon institutional controls. This is so even in business concerns. It is the personal quality of the administration that determines the efficiency. In abnormal periods such as wars, such a system is very ticklish. When the enemy force is weak, and the victory is foreseeable, the prestige of the Government and the spirit of the people would be both high. Efficiency of administration would increase. Contrariwise, when the enemy force is strong, and the warfare is prolonged, the prestige of the Government and the spirit and endurance of both the people and Government officials would be much reduced. Efficiency would be bottom low and corruption may arise anywhere.

The National Government before the war with its military forces gradually unifying China during the ten years between 1927 and 1937, was considerably more efficient than the Peking Government and the Imperial Government during the later years of the Ching Dynasty. The efficiency and prestige of the Government was climbing up to the peak in 1936 - 1937 when the country was practically unified. In fact it was the fear of the potential threat of an efficient and unified China that moved the Japanese to start the war.

The war with Japan was singular in its character in Chinese history. The extreme difference between the military forces of the belligerent countries was unique. Save with foreign assistance, there was no hope of final victory. Yet, during the first phase of the war, the spirit of the people was high. Later, with the relatively industrialized cities occupied and the whole country blockaded, final victory seemed very remote. Impatience was growing. The war destruction, the economic isolation of the interior from the outside world, the monetary inflation, all impoverished the people. To prevent inflation from running wild the Government had to keep the salaries of Government employees far behind the rise of prices. In fact, the real income from salaries for many of the Government employees is even lower than the income of manual workers, not speaking of that of business men. The more able and energetic the Government employees, the more they were inclined to leave the Government and to start their own business instead of Government. Those who remain in the Government had to

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obtain other incomes to supplement their regular salaries in order that they may not be starved. The better ones might secure a concurrent job in schools or business concerns, and the worse ones had to resort to irregular means. It was only the hope of a final victory over the Japanese by allied nations that kept up the morale.

In the Japanese occupied areas, while the economic situation was much better off than in the interior, there was another element leading to corruption. Many of the officials in the puppet Government joined the regime half heartedly just for a living. They tried to boycott or disobey orders whenever possible. Corruption became the fashion and can be proud of, rather than crime. It was the supremacy of the Japanese military force and the iron hand of the Japanese administration that maintained order in the occupied areas.

After V. J. Day, internal hostilities broke out and the situation became even more disappointing than during the years of the Japanese war. The inflation, which was started during the war, cannot be checked with the dislocated productive machinery. To prevent laborers from turning to the Communists, the Government had assisted them to increase their wages so that, although the national productivity is much reduced, the real income is much higher than pre-war years. The higher wage together with lower productivity raised the production cost, which in turn raised general prices and decreased employment and production. This factor, in addition to the civil war, means more vigorous inflation. As a result, real income of the lower bracket of Government employees fell much below those of unskilled workers. On the other hand, the habits and technique of corruption as acquired during the Japanese occupation applied more widely to the present administration after the Government returned to banking. The discipline before V. J. Day toward early peace is gone. The iron hand of the Japanese administration are lacking. There is nothing more to keep the morale. It is understandable that there cannot be any incentive to work when the income is below the subsistence level without any foresee the future. Efficiency is low and corruption prevails everywhere when supreme supervision is insufficient.

To restore morale and efficiency, it is necessary to have (1) a foreseeable peace either by military or by political settlement, and (2) a stable income for Government officials sufficient for a decent living.

To increase efficiency by raising the salaries of Government employees, there involves a dangerous vicious circle. For efficiency

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cannot be increased overnight. During the transitional period after the raise of salaries but before the improvement of efficiency, the increased note issue means an accelerated inflation. This will very likely nullify the whole effort. The difficulty in improving the efficiency of the military force is even greater. High expenses are needed to demobilize the inefficient troops and to rearm the others. The burden is too heavy for a country poverty-stricken by the eight years' war with Japan and two years of internal struggle.

With the political differences unsettled and military operations continuing,^{one} of the most effective ways to regain morale of the people and to increase efficiency of the Government is substantial economic assistance from outside. Judging from past experience, prospects of foreign assistance arouse or depress the morale just as much as internal political and military situation. By substantial economic assistance it will psychologically give hope to the people, and materially improve the economic situation of the whole country in general and the living conditions of Government employees in particular. Both the psychological and material security will increase the administrative efficiency.

PLAN FOR CURRENCY REFORM

In China, as in many countries under hyper-inflation, commodity prices rise more than proportionally to note issue. The difference represents an increase in the velocity of circulation of money due to a loss of confidence of the people towards the currency. At the present, the aggregate purchasing power of the total currency in circulation in China is only one-fourth of that before the war. In other words, because of the flight from currency, each dollar at present is doing the function of four dollars before the war. This is a crucial problem during inflation. Should the people regain their confidence towards the currency and each dollar will do no more than one dollar's worth before the war, prices will fall to one-fourth even if the total circulation remains the same. Or, looking at the things from another point of view, prices will not rise even if the currency in circulation is increased by three times.

The above is the basic reason for the silver scheme in stabilizing Chinese currency. In China, people have been accustomed for centuries to the use of silver as a medium of exchange. They measure silver ingots by weight as a means of payment during transactions. Later, after the Mexican dollars were introduced into China, the Chinese Government adopted the coinage system for silver, and indicated the weight of the dollar on the surface of the coins. At the same time, the government issued silver that maintained

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the monetary value. Up to 1934, all notes were redeemable into silver coins. There were also occasional runs on the banks whenever free-redemption was in question. The Chinese people had only three years of experience in using irredeemable notes before the outbreak of the war with Japan. Even during that period, silver coins were still esteemed highly and used extensively as a store of value especially among the farmers in the countryside.

It is therefore no wonder that, under such a background, confidence towards an irredeemable paper money may break down anytime in China during a major war, especially under such conditions as these before Pearl Harbor when there was practically no hope of victory. In fact it is almost unusual that the velocity of circulation did not rise by more than four times after eight years of war with Japan and then years of inflation.

At present, one measure which may immediately restore the confidence of the people towards the currency is to issue silver coins and to announce that the present notes in circulation is redeemable into silver coins at a fixed conversion ratio. It is expected that the contemplated silver coins will be much welcomed by the Chinese people. At the present everyone who possesses money will try to spend it as fast as possible. The farmers who are the original producers of the major national products in China choose to keep their agricultural produce as long as they can afford to until they are ready to purchase something from some other producers. They lost the confidence towards the currency. On the other hand, they are used to praise high either silver taels or silver coins, and choose to bury them underground instead of lending them for interest. Such a psychology and habit is well prepared to accept silver as a store of value and give up their holdings of foodstuffs the carrying cost of which is high. The free redemption of the present notes into silver coins will also give a value to the notes. The release of foodstuff by the farmers will not only increase the food supply in the market, but also reduce the waste and loss during storage. If the present paper notes were kept by an average income recipient for 5 days before they were spent, while the silver coins may be kept for 15 days, the velocity of circulation is reduced to 1/3. This enables the increase in the currency in circulation by 2/3 without any further increase in price.

However, the plan will not work if only a small quantity of silver such as the present stock of the Government is on hand. The present stock is sufficient for no more than one month's use. It can hardly have any

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to the issuing of notes, the original exchange ratio between the old and new yuans could not be maintained. The silver coin will be either disappear from the market or transacted at premium with the paper notes. Worse still, it means the creation of a new but independent currency used as an alternative to the paper notes as a medium of exchange and measure of value, just as the gold bars and U.S. notes were used before the prohibition. Once the official exchange ratio between the silver coins and the paper notes could not be maintained, the mere fact will serve as a hindering force if attempt is made to adopt any other programs of currency reform.

It is true that the present inflation is chiefly due to the Government deficit which increases note issue. But inflation itself also causes the deficit. During inflation, assessment of taxable income is extremely difficult. It does not only increase evasion, but the prolonged procedure of assessment under continuously rising prices also reduces the purchasing power of money of the tax received. For example, income tax is not received by the Government until on the average nine months after the ending of the accounting period when prices have risen many times. Also specific duties can never catch up prices, and tax in kind, which is one way to maintain the purchasing power of the tax received, it is costly. On the other hand, during inflation when everyone flees from currency, bonds cannot be issued to cover the deficit. Thus, with an initial period of stability, it gives a breathing spell for fiscal reforms to increase revenue, and the use of silver furnishes an excellent means of stable value for issuing bonds. In this way, the need for note issue to finance deficit may be reduced and further inflation after the initial period of stability also checked.

It may sound unbelievable at first that to stabilize the currency of a country with 500 million people, no more than 350-600 million ounces of silver are needed, besides what China has on hand, the exact amount depending on the technical detail of the scheme. But that amount of silver, after being coined, means more than one-half of the pre-war currency in circulation, and is sufficient to maintain a relatively stable price level for an initial period of one year. The cost is low in doing it this way.

It is sometimes criticized that the introduction of silver coins in the midst of the continuing inflation would result in hoarding of the coins and their disappearance from circulation. In fact, the essence of the silver plan is to utilize the very traditional preference of the people for silver to stabilize the currency. If, after silver coins are issued instead of the present paper notes, people hoard them as they are issued, further inflation will be stopped. After prices stop rising, people will cease their

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flight from currency to buy goods, and there will be a general feeling of the scarcity of money, for then each dollar will not be able to serve the purpose of four dollars. Silver coins will again return to the market. The psychology to appreciate silver is a merit rather than pitfall for adopting the silver plan.

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It is also sometimes objected that, by adopting a silver standard China would be subjecting her monetary system to all the vicissitudes of the world price of silver. But the use of silver coins does not necessarily imply a return to a silver standard. Silver coins may be used as tokens just as half-dollars, quarters, dimes and nickels are used in the United States. As a medium of exchange it may well be substituted by nickel coins or paper notes. It is only because of the tradition of the Chinese people to prefer silver that it is chosen as the coinage material for the purpose of stabilization. The exchange rate is to be fixed with a gold standard country in such a way that the exchange value of the silver coin is slightly over-valued as compared with the silver price so that the fluctuation of silver price will not affect foreign exchange rate and the general price level.

THE SILVER PROGRAM

1. The unit of the new currency yuan will be equivalent to either US 0.25 or US 0.33 1/3, depending on the prospect of silver price at the time of issuing the coins.

2. Silver coins with the denominations of one yuan and two yuan will be issued. The specifications of the coins are as follows:

| Type of coins | Gross Weight | Fineness | Diameter | Melting Point (silver price per oz.) with exchange rate of | |
|-----------------|--------------|-----------------|--------------|--|--------------------------|
| One <u>yuan</u> | 0.4 oz. | 720/1000 silver | 1.201 inches | US\$0.25 US\$0.875 | US\$0.33 1/3 US\$1.16 |
| Two <u>yuan</u> | 0.7 oz. | 720/1000 silver | 1.417 inches | US\$0.99 | US\$1.32 |

3. Pure nickel will be used for making 5-cent, 10-cent and 20-cent pieces, and copper will be used for 1-cent.

4. The conversion ratio between the new yuan and the present fapi will be determined by the average price index in China at time of issuing the new currency according to the following formula:

$$\frac{\text{New exchange rate} \times \text{Chinese price index, 1937 - 100}}{\text{Prewar exchange rate} \times \text{U. S. price index, 1937 - 100}}$$

The prewar exchange rate was US\$0.295 per yuan. Assuming that U.S.

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prices are on the average 80% higher at the present than in 1937, then the conversion ratio between the new yuan and paper fapi may be determined as follows:

| No. of fapi to one <u>yuan</u> | Average price index in China, 1937 = 1 with new foreign exchange rate of | |
|-----------------------------------|---|---------------------------------|
| | US\$0.25 to 1 <u>yuan</u> | US\$0.33 1/3 to one <u>yuan</u> |
| 10,000 | 21,240 | 15,930 |
| 20,000 | 42,480 | 31,860 |
| 30,000 | 63,720 | 47,790 |
| 40,000 | 84,960 | 63,720 |
| 50,000 | 106,160 | 79,650 |
| 60,000 | 127,440 | 95,580 |

According to the price level at the middle of October, 1947, which is about 55,000 times as before the war for China as a whole, the conversion ratio should be 25,000 to one if the US\$ exchange rate is to be fixed at US\$0.25 per yuan, or 35,000 to one if the exchange rate is to be US\$0.33 1/3 per yuan.

5. At the issuance of the silver coins, the Government will announce the suspension of further issuing of the present fapi. Fapi will circulate with and be redeemable into silver coins at the fixed conversion ratio.

6. Paper notes under the new currency system will not be issued until the confidence of the people towards the currency is well established. Gold, silver, and foreign exchange will be used as reserve in case the paper notes under the new currency system are issued. The new notes will be redeemable in silver coins.

7. The requirement of silver for the new currency system depends much on the foreign exchange rate and the conversion ratio between fapi and the new coins to be fixed. With an average price level of 55,000 times as before the war in the middle of October, 1947, the requirement may be estimated as follows:

| | Scheme I | Scheme II |
|--|---------------------------|-------------------------|
| US\$ exchange rate of new coins (a) | US\$1=4 <u>yuan</u> | US\$=3 <u>yuan</u> |
| Purchasing power parity of US\$ exchange of <u>fapi</u> when price in China is 65,000 times as 1937 as determined by the formula Chinese price level ÷ (0.295 x U. S. price level) (b) | US\$1=120,000 <u>yuan</u> | |
| Conversion ratio between new currency and <u>fapi</u> (b) ÷ (a) | 30,000 | 40,000 |
| 12 months requirement of coins in terms of <u>fapi</u> | 74 trillion <u>yuan</u> | |
| Silver coins equivalent | 2.5 billion <u>yuan</u> | 1.9 billion <u>yuan</u> |
| Silver requirement | | |
| One half to be one <u>yuan</u> coins | | |
| One half to be two <u>yuan</u> coins-- | 675 million oz. | 517 million oz. |
| Deduct: Silver in stock ----- | 40 million oz. | 40 million oz. |
| Net silver requirement ----- | 635 million oz. | 467 million oz. |
| Cost at US\$0.70 per oz. ----- | US\$445 million | US\$327 million |

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With wholesale prices in U.S.A. at the present about 60% higher 25X1A
 than that in 1927, the purchasing power parity of exchange between Chinese
 and U. S. dollars is calculated according to the formula.

| Average price index in China 1937=1 | <u>Chinese price index 1937=1</u> U. S. price index |
|--|--|
| 50,000 | 94,500 |
| 60,000 | 113,000 |
| 70,000 | 132,000 |
| 80,000 | 151,000 |
| 90,000 | 170,000 |
| 100,000 | 189,000 |

Exchange rate according
 to purchasing power parity

-and-

CONFIDENTIAL

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